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SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE
(EDRC) REVIEW OF THE UK

REF: (A) GDR(77)6; (B) LONDON 1538

1. SUMMARY: IN REFDOC CIRCULATED FOR FEBRUARY 24 EDRC
REVIEW OF UK, SECRETARIAT EMPHASIZES SHARP DETERIORATION
IN UK ECONOMIC SITUATION SINCE SPRING OF 1976 AND NOTES
IN PARTICULAR THAT GDP STAGNATED SINCE FIRST QUARTER OF
LAST YEAR, INFLATION REMAINED HIGH AND CURRENT ACCOUNT
DEFICIT REACHED NEARLY \$3 BILLION FOR YEAR AS WHOLE,
WHILE STERLING WAS OBJECT OF SPECULATIVE ATTACK.
SECRETARIAT STATES THAT EXPANSIONARY UK MONETARY POLICY
PROBABLY CONTRIBUTED TO PRESSURES ON STERLING IN SPRING
AND IN AUTUMN, BUT DOES NOT FEEL THAT LACK OF MONETARY
RESTRAINT WAS AN IMPORTANT INFLATIONARY FACTOR.
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SECRETARIAT OBSERVES THAT RESTRICTIVE POLICY PACKAGE
ADOPTED IN DECEMBER AS CONDITION FOR IMF STANDBY, IMF
CREDIT ITSELF AND BASLE AGREEMENT ON STERLING BALANCES
HAVE FINALLY SUCCEEDED IN QUELLING SPECULATION AGAINST
POUND. SECRETARIAT FORESEES CONSIDERABLE IMPROVEMENT IN
UK ECONOMIC PERFORMANCE THIS YEAR: DECELERATION OF
INFLATION RATE (POSSIBLY TO SINGLE DIGIT BY YEAREND);

AND NARROWING OF CURRENT ACCOUNT DEFICIT (WITH SURPLUS IN SECOND HALF OF YEAR). INTERNATIONAL SUPPORT AND STRICT DEMAND MANAGEMENT POLICY STANCE SHOULD CONTINUE TO MAINTAIN CONFIDENCE IN VALUE OF POUND. HOWEVER, REAL GDP GROWTH LIKELY TO BE SLOW (1 PERCENT) AND NUMBER OF UNEMPLOYED COULD REACH 1.5 MILLION. SECRETARIAT RECOMMENDS THAT HMG (A) CONTINUE TO GIVE TOP PRIORITY IN SHORT RUN TO FIGHT AGAINST INFLATION BY MAINTAINING STRICT DEMAND MANAGEMENT POLICIES AND BY TAKING STEPS TO INSURE EFFECTIVE FOLLOWUP TO PRESENT PAY AGREEMENT; (B) PROPOSE UNIFORM PERCENTAGE INCREASE IN SALARIES IN PHASE III (POST-AUGUST, 1977) PAY AGREEMENT TO AVERT FURTHER COMPRESSION OF WAGE DIFFERENTIALS. (SECRETARIAT ALSO SUGGESTS THAT CAUTIOUS TAX REDUCTIONS MIGHT BE IN ORDER AT HIGH AND LOW ENDS OF INCOME SCALE.) NOTING THAT EXPORT REVENUES FROM OIL WILL RELAX EXTERNAL CONSTRAINT TO GROWTH OVER MEDIUM-TERM, SECRETARIAT EXAMINES VARIOUS POLICY ALTERNATIVES AND SUGGESTS POLICY PATH WHICH AIMS NEITHER AT MAXIMIZING CURRENT ACCOUNT SURPLUS, NOR AT FULL EMPLOYMENT, BUT RATHER AT "OPTIMAL" MIX OF THESE OBJECTIVES. SECRETARIAT ALSO URGES UK TO PUT MORE EMPHASIS ON STEADY DEMAND MANAGEMENT POLICIES RATHER THAN ON "FINE TUNING." ACTION REQUESTED: PARTICULARLY SINCE U.S. IS AN EXAMINING COUNTRY, MISSION WOULD APPRECIATE COMMENTS/QUESTIONS WHICH COULD USEFULLY BE POSED AT REVIEW. (NOTE: REP FROM AMEMBASSY LONDON WILL PARTICIPATE IN REVIEW.) END SUMMARY

2. SHORT-TERM PROSPECTS; DOMESTIC SITUATION IN 1976:
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SECRETARIAT ESTIMATES THAT REAL GDP HAS BEEN NEARLY STAGNANT SINCE FIRST QUARTER OF 1976 AFTER SHORT-LIVED PICKUP IN EARLY MONTHS OF YEAR. PRIVATE CONSUMPTION ROSE marginally AS 1 PERCENT DECLINE IN REAL DISPOSABLE INCOME WAS OFFSET BY 1-1/2 PERCENT FALL IN SAVINGS RATIO. IN SECRETARIAT VIEW, DROP IN SAVINGS RATE RESULTED FROM SQUEEZE ON DISPOSABLE INCOME AND FROM INCREASED PROPORTION OF TRANSFER PAYMENTS (OUT OF WHICH PROPENSITY TO SPEND IS HIGHER THAN AVERAGE) IN PERSONAL INCOME. BOTH PUBLIC AND PRIVATE INVESTMENT REGISTERED DECLINE ON AVERAGE IN 1976, ALTHOUGH LATTER ACCELERATED SOMEWHAT FROM FIRST QUARTER OF YEAR ONWARD. LABOR MARKET SITUATION DETERIORATED SERIOUSLY.

3. WAGES AND PRICES: SECRETARIAT OBSERVES THAT UNDERLYING RATE OF INFLATION IN UK REMAINED RELATIVELY STABLE (13-15 PERCENT AT ANNUAL RATE) THROUGHOUT 1976. SECRETARIAT NOTES THAT NORMS FOR WAGE INCREASES SET UNDER

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PHASE I (AUGUST, 1975 - AUGUST, 1976) AND PHASE II
(AUGUST, 1976 - AUGUST, 1977) PAY POLICIES HAVE BEEN
LARGELY RESPECTED WITH RESULT THAT GROWTH OF AVERAGE
EARNINGS SLOWED CONSIDERABLY. RELATIVELY MODERATE ACCEL-
ERATION OF AVERAGE EARNINGS TOGETHER WITH SOME INCREASE
IN PRODUCTIVITY IN 1976 LED TO DECELERATION TO 10 PERCENT
OF RISE OF UNIT LABOR COSTS (VS. INCREASE OF 36 PERCENT
IN YEAR TO MID-1975). HOWEVER, SECRETARIAT STATES THAT
ACTUAL RATE OF INFLATION ACCELERATED SHARPLY DURING YEAR
DUE TO DOMESTIC PRICE EFFECTS OF SUBSTANTIAL DEPRECIATION
OF POUND SINCE MARCH, 1976 AND TO STEEP RISE IN FOOD
PRICES. (ANNUAL RATE OF FOOD PRICE INCREASE REACHED
40 PERCENT IN FOURTH QUARTER OF 1976.) SECRETARIAT ESTI-
MATES THAT RETAIL PRICES INCREASED BY OVER 16 PERCENT IN
1976 AND FEELS THAT PROGRESSIVE RELAXATION OF PRICE CON-
TROLS LAST YEAR HAD MINIMAL EFFECT ON INFLATION RATE.

4. OUTLOOK FOR 1977: ON DOMESTIC SIDE, SECRETARIAT
EMPHASIZES THAT MAJOR UNCERTAINTY IN 1977 IS FUTURE
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COURSE OF INFLATION. WHILE NOTING THAT EXTERNAL SITUATION AND EXCHANGE RATE SHOULD NOT BE DISRUPTIVE INFLUENCES THIS YEAR, SECRETARIAT ADDS THAT SEVERAL INFLATIONARY PRESSURES ARE ALREADY IN PIPELINE OR COULD MATERIALIZE, INCLUDING: (A) LAGGED EFFECTS OF STERLING DEPRECIATION; (B) EFFECTS ON FOOD PRICES OF ELIMINATING FOOD SUBSIDIES AND POSSIBLE DEVALUATION OF "GREEN POUND;" (C) INCREASE IN EMPLOYERS' NATIONAL INSURANCE CONTRIBUTIONS AND (D) RISE IN CERTAIN ADMINISTRATIVE PRICES. ACCORDING TO SECRETARIAT, THESE FORCES WILL TEND TO OFFSET FAVORABLE EFFECTS ON UNIT LABOR COSTS OF CONTINUED WAGE RESTRAINT. (SECRETARIAT ASSUMES THAT POST-AUGUST PAY AGREEMENT WILL PROVIDE AVERAGE RISE IN EARNINGS SIMILAR TO THAT UNDER PRESENT AGREEMENT -- I.E., 8-9 PERCENT WITH HALF OF RISE DUE TO INCREASE IN BASIC PAY AND REMAINDER RESULTING FROM WAGE DRIFT.) SECRETARIAT FORECASTS 13 PERCENT AVERAGE INCREASE IN CONSUMER PRICES IN 1977, BUT NOTES THAT ANNUAL RATE OF PRICE INCREASE SHOULD DECELERATE STRONGLY DURING YEAR, POSSIBLY FALLING INTO SINGLE DIGIT RANGE BY YEAR END.

5. ASSUMING MODERATE GROWTH OF AVERAGE EARNINGS AND SOME FISCAL DRAG, SECRETARIAT PROJECTS 3-1/2 - 4 PERCENT DECLINE IN REAL DISPOSABLE INCOME IN 1977, BUT INDICATES THAT FURTHER DECLINE IN SAVINGS RATIO COULD HOLD DECLINE IN REAL PRIVATE CONSUMPTION SPENDING TO 1.75 PERCENT. SECRETARIAT SEES 10-12 PERCENT RISE IN REAL MANUFACTURING INVESTMENT DESPITE RESTRICTIVE DEMAND MANAGEMENT POLICIES AND POINTS TO FOLLOWING MAIN SUPPORTIVE FACTORS: (A) INCREASE IN INDUSTRIAL EXPORTS AND IMPROVED FINANCIAL POSITION OF FIRMS (BOTH FACTORS LINKED TO DEPRECIATION); (B) CONSISTENTLY BUOYANT BUSINESS INTENTIONS SURVEYS RE EXPANSION PLANS FOR 1977; (C) FIRMS IN SOME SECTORS CLOSE TO CAPACITY AND (D) OFFICIAL FINANCIAL ASSISTANCE UNDER NEW INDUSTRIAL STRATEGY WILL HELP OTHER SECTORS. HOWEVER, SECRETARIAT NOTES THAT PUBLIC INVESTMENT, RESIDENTIAL LIMITED OFFICIAL USE

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CONSTRUCTION AND INVESTMENT IN NORTH SEA WILL ALL DECLINE AND THAT GROSS FIXED CAPITAL FORMATION COULD FALL BY 3-1/2 PERCENT.

6. SECRETARIAT EXPECTS THAT POSITIVE CONTRIBUTION FROM INVENTORY ACCUMULATION AND FROM SWING IN REAL FOREIGN BALANCE WILL MORE THAN OFFSET DECLINE IN DOMESTIC DEMAND AND PROJECTS 1 PERCENT INCREASE IN REAL GDP IN 1977 (SOMEWHAT LESS IF OIL PRODUCTION IS EXCLUDED). MODEST GDP GROWTH, LIKELY SHIFT IN PATTERN OF GROWTH AWAY FROM LABOR

INTENSIVE ACTIVITIES (NOTABLY AWAY FROM PUBLIC CONSUMPTION) LEAD SECRETARIAT TO FORECAST SMALL RISE TO 1.5 MILLION IN NUMBER OF UNEMPLOYED. (SECRETARIAT ASSUMES THAT SELECTIVE EMPLOYMENT CREATION PROGRAMS, DUE TO EXPIRE IN APRIL, 1977, WILL CONTINUE THROUGHOUT YEAR, BUT WILL NOT BE EXPANDED.)

7. CURRENT ACCOUNT: UK CURRENT ACCOUNT POSITION FOLLOWED ROLLERCOASTER PATH IN 1976 -- IMPROVING EARLY IN YEAR, DETERIORATING SHARPLY BETWEEN MARCH AND NOVEMBER AND MOVING INTO SURPLUS IN DECEMBER. SECRETARIAT NOTES THAT (TRADE WEIGHTED) EFFECTIVE STERLING EXCHANGE RATE, PARTLY INFLUENCED BY CURRENT ACCOUNT MOVEMENTS, PLUMMETED BY 20 PERCENT BETWEEN MARCH AND OCTOBER, BUT STOOD 7 PERCENT ABOVE OCTOBER TROUGH IN MID-JANUARY, 1977. SECRETARIAT POINTS TO FOLLOWING SPECIAL FACTORS WHICH BOOSTED IMPORTS

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IN 1976: (A) DROUGHT; (B) RUMORS OF IMPOSITION OF IMPORT CONTROLS; (C) THREATENED SEAMEN'S STRIKE; (D) EXCHANGE RATE UNCERTAINTY AND (E) LARGE PURCHASES OF NORTH SEA PRODUCTION INSTALLATIONS. SECRETARIAT ADDS, HOWEVER, THAT EVEN ACCOUNTING FOR ABOVE SPECIAL FACTORS, GROWTH OF IMPORTS WAS LARGE COMPARED WITH THAT OF DOMESTIC

DEMAND, IMPLYING THAT UK DOMESTIC SUPPLIERS HAVE EXPERIENCED INCREASING DIFFICULTY IN MEETING FOREIGN COMPETITION.

8. SECRETARIAT ESTIMATES THAT UK EXPORTS ROSE AT 17 PERCENT ANNUAL RATE IN FIRST HALF OF 1976 (ROUGHLY IN LINE WITH MARKET GROWTH), BUT ROSE AT ANNUAL RATE OF ONLY 3 PERCENT IN SECOND HALF COMPARED WITH 7 PERCENT GROWTH OF MARKETS. SECRETARIAT SPECULATES THAT UNFAVORABLE PRODUCT COMPOSITION OR LAG IN EFFECT OF DEPRECIATION ON EXPORT VOLUMES MIGHT HELP EXPLAIN UK'S POOR EXPORT PERFORMANCE, BUT ALSO NOTES THAT UK TERMS OF TRADE DECLINED BY ONLY 1 PERCENT BETWEEN 1975 AND 1976 (DESPITE 14-1/2 LIMITED OFFICIAL USE

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PERCENT DECLINE IN EFFECTIVE STERLING EXCHANGE RATE) DUE TO RISE IN STERLING EXPORT PRICES. IN EXPLAINING THIS DEVELOPMENT, SECRETARIAT STATES THAT (A) STRENGTH OF WORLD DEMAND MAY HAVE JUSTIFIED PRICE INCREASES, SUGGESTING THAT UK IS INCREASINGLY BECOMING A PRICE-TAKER ON WORLD MARKET; (B) INCREASING PROPORTION OF UK EXPORTS DENOMINATED IN FOREIGN CURRENCY; (C) UK FIRMS STROVE TO RESTORE ERODED PROFIT MARGINS. MOREOVER, SECRETARIAT EXPRESSES DOUBT AS TO WHETHER IMPROVEMENT IN RELATIVE COST POSITION OF UK WILL BE SUFFICIENT TO IMPROVE UNDERLYING COMPETITIVENESS OF UK ECONOMY IN FACE OF "DISMAL PRODUCTIVITY PERFORMANCE" OF UK INDUSTRY AND UK'S POOR COMPETITION RECORD IN NON-PRICE AREA (I.E., SERVICE, QUALITY).

9. HAVING CRITICIZED AT LENGTH UK EXPORT PERFORMANCE, SECRETARIAT FORECASTS INCREASE IN UK EXPORT VOLUMES IN 1977 EQUAL TO THAT OF UK MARKETS; I.E., 6-7 PERCENT AND CITES LAGGED EFFECT OF DEPRECIATION AS MAIN FACTOR LEADING TO THIS RESULT. IMPORT GROWTH WILL BE DEPRESSED BY SLUGGISHNESS OF DOMESTIC DEMAND, AND BY IMPORT SUBSTITUTION RESULTING FROM DEPRECIATION. FINALLY, SECRETARIAT EXPECTS NORTH SEA OIL PRODUCTION TO MAKE \$2-1/2 BILLION POSITIVE CONTRIBUTION TO CURRENT ACCOUNT POSITION AND PROJECTS REDUCTION OF CURRENT ACCOUNT DEFICIT TO \$1/2 BILLION FOR 1977 AS A WHOLE AND SURPLUS IN SECOND HALF OF YEAR.

10. FISCAL AND MONETARY POLICY; FISCAL POLICY: SECRETARIAT NOTES THAT FISCAL POLICY BECAME PROGRESSIVELY MORE RESTRICTIVE IN 1976 AND CULMINATED IN DECEMBER PACKAGE ADOPTED AS PART OF CONDITIONALITY PROVISIONS OF IMF LOAN. SECRETARIAT ESTIMATES THAT EFFECT OF DECEMBER MEASURES SHOULD BE TO REDUCE PUBLIC SECTOR BORROWING REQUIREMENT (PSBR) FROM 9-1/2 PERCENT OF GDP IN FY1976-77 TO 6.25 PERCENT IN FY1977-78 AND TO JUST OVER 5 PERCENT IN

FY1978-79. SECRETARIAT NOTES THAT DECEMBER, 1976 EXPEN-
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DITURE CUTS WERE NOT CONSIDERABLE IN THEMSELVES, BUT THAT
COMBINED IMPACT OF THESE CUTS AND THOSE MADE IN JULY
WOULD BE TO REDUCE 1977 GDP GROWTH BY 1/4 - 1/2 PERCENT.
SECRETARIAT STATES THAT EXPANDED USE OF "CASH LIMITS" ON
SPENDING WILL IMPROVE HMG'S CHANCES OF FULFILLING ITS
STATED BUDGETARY INTENTIONS.

11. MONETARY POLICY: IN SECRETARIAT VIEW, UK MONETARY
POLICY IN 1976 MUST TAKE SIGNIFICANT MEASURE OF BLAME
FOR BURSTS OF EXCHANGE RATE INSTABILITY WHICH OCCURRED
DURING THE YEAR. FAILURE OF HMG TO MOVE TOWARD MONETARY
RESTRICTION WHEN INITIAL PRESSURE ON STERLING DEVELOPED
IN MARCH, 1976 FUELED EXPECTATIONS OF FURTHER DEPRECI-
ATION AND OF EVENTUAL RISE IN INTEREST RATES. RESULT,
ACCORDING TO SECRETARIAT, WAS ACCELERATION IN MONETARY
GROWTH; PRIVATE SECTOR BORROWED TO FINANCE "LEADS AND
LAGS" AND TREASURY WAS FORCED TO PLACE DEBT WITH CENTRAL
BANK. PRESSURE ON EXCHANGE RATE WAS ALLEVIATED BY DRAS-
TIC TIGHTENING OF MONETARY POLICY IN NOVEMBER, 1976.
FINALLY, SECRETARIAT INDICATES THAT TIGHT MONETARY CON-
TROLS, SUCCESSFUL NEGOTIATION OF IMF PACKAGE AND BASLE
AGREEMENT TO BACK UP STERLING BALANCES SHOULD HELP ASSURE
A QUIESCENT EXCHANGE MARKET IN 1977.

12. WHILE PINNING MUCH OF BLAME FOR EXCHANGE RATE

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INSTABILITY ON UK MONETARY POLICY, SECRETARIAT DOES NOT FEEL THAT EXCESSIVE MONETARY GROWTH WAS AN INFLATIONARY FACTOR IN 1976. RATHER, LARGE BUILD-UP IN DEPOSITS REPRESENTED TEMPORARY HOLDINGS BY INSTITUTIONS WHICH WERE AWAITING RISE IN INTEREST RATES TO POUNCE ON "GUILTS." SECRETARIAT REFERS TO TARGET FOR DOMESTIC CREDIT EXPANSION (DCE) SET BY HMG FOR FY1976-77, BUT STATES THAT LACK OF DEMONSTRATED EMPIRICAL RELATIONSHIP IN UK BETWEEN GROWTH OF MONEY SUPPLY AND PRICE AND INCOME DEVELOPMENTS MAKES RESTRICTIVENESS OF SUCH A TARGET DIFFICULT TO ASSESS

13. MEDIUM-TERM POLICY: SECRETARIAT'S ANALYSIS OF MEDIUM-TERM PROSPECTS AND POLICY IMPLICATIONS BEGINS FROM PREMISE THAT NORTH SEA OIL PRODUCTION WILL SIGNIFICANTLY RELAX EXTERNAL CONSTRAINT ON GROWTH. SECRETARIAT SEES UK AS HAVING THREE BASIC POLICY ALTERNATIVES, (A) RESTRAIN CONSUMPTION TO BUILD UP LARGE CURRENT ACCOUNT SURPLUS; (B) GO FOR FULL EMPLOYMENT AND (C) MIDDLE STRATEGY DESIGNED TO ESTABLISH CONDITIONS FOR LIMITED OFFICIAL USE

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STEADY NON-INFLATIONARY GROWTH, LED BY PRODUCTIVE INVESTMENT AND EXPORTS. SECRETARIAT ACKNOWLEDGES THAT ALTERNATIVE (A) IS ATTRACTIVE, BUT FEELS THAT MODERATE GROWTH OF CONSUMPTION IS NECESSARY TO INSURE THAT RESOURCES RELEASED FROM PUBLIC SECTOR ARE "PICKED UP" BY EXPANSION OF INVESTMENT, THE KEY TO LONG RUN HEALTH OF UK ECONOMY. REPRESSION OF PRIVATE CONSUMPTION COULD ALSO LEAD TO WAGE EXPLOSION AND SOCIAL UNREST. OPTION (B) HAS OBVIOUS DRAWBACK OF EMPHASIZING CONSUMPTION AT EXPENSE OF EXPORTS AND INVESTMENT. SECRETARIAT CHOOSES OPTION (C) AND PRESENTS "SCENARIO" TO 1982 BASED ON THAT OPTION WITH FOLLOWING MAIN FEATURES: (A) 6 PERCENT AVERAGE ANNUAL GROWTH OF NON-OIL EXPORT VOLUMES, (B) AVERAGE ANNUAL REAL GDP GROWTH (3.5 OR 4 PERCENT INCLUDING OIL) WHICH WOULD PRODUCE CURRENT ACCOUNT SURPLUS (CUMULATIVE SURPLUS OF \$11 BILLION BETWEEN 1978-1982) TO AVOID EXTERNAL CRISES, BUT STILL IMPLY INCREASE OF NON-OIL CURRENT ACCOUNT DEFICIT TO \$6.5 BILLION IN 1982 (VS. \$3.5 BILLION IN 1976); (C) OVERALL SURPLUS WOULD BE USED FOR

REPAYMENT OF OFFICIAL DEBT, RUNDOWN OF STERLING BALANCES, AND BUILD UP OF RESERVES; (D) 9 PERCENT AND 3 PERCENT AVERAGE ANNUAL RISE RESPECTIVELY IN REAL MANUFACTURING INVESTMENT AND REAL PRIVATE CONSUMPTION; (E) FALL IN UNEMPLOYMENT RATE TO 3 PERCENT BY 1982.

14. CONCLUSIONS: BASED ON ANALYSIS REFD0C, SECRETARIAT SUGGESTS THAT EDRC REACH FOLLOWING MAIN CONCLUSIONS:

(A) CONTINUATION OF AN OVERALL RESTRICTIVE POLICY DURING 1977 IS A PREREQUISITE FOR SOLVING THE UNITED KINGDOM'S MAIN ECONOMIC PROBLEMS.

(B) INSOFAR AS RENEWAL OF THE SOCIAL CONTRACT WOULD SEEM TO BE AN ESSENTIAL ELEMENT IN CURBING INFLATIONARY PRESSURES, SELECTIVE TAX REDUCTIONS AND CONTINUATION OF EMPLOYMENT-SUPPORTING SCHEMES SHOULD BE ENVISAGED IF THIS LIMITED OFFICIAL USE

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COULD HELP ACHIEVE A MODERATE PAY SETTLEMENT.

(C) WHEN DESIGNING LONGER-RUN POLICIES, THE AUTHORITIES MAY WISH TO BEAR IN MIND THE NEED FOR A GRADUAL MOVE TO A MORE EXPANSIONARY POSTURE AND TO ENCOURAGE INVESTMENT AND EXPORT-LED GROWTH.

15. COMMENT: (A) SECRETARIAT NOTES THAT DEGREE OF TIGHTNESS OF MONETARY POLICY IN 1977 IMPLIED BY LIMITS ON GROWTH OF DCE IS DIFFICULT TO ASSESS BECAUSE OF ABSENCE OF EMPIRICAL RELATIONSHIP IN UK BETWEEN GROWTH OF MONETARY AGGREGATES AND INCOME/PRICE DEVELOPMENTS. HOWEVER, IT IS CLEAR THAT UK MONETARY POLICY HAS INFLUENCED EXCHANGE RATE MOVEMENTS WHICH IN TURN HAVE HAD EFFECTS ON DOMESTIC PRICES AND INCOMES. MISSION WOULD MAKE THIS POINT AND WOULD INDICATE AT REVIEW THAT ESTABLISHMENT OF TARGET FOR DCE GROWTH IS A SIGNIFICANT POSITIVE DEVELOPMENT. MISSION WOULD ALSO ASK UK REP FOR ASSESSMENT OF RESTRICTIVENESS IMPLIED BY DCE TARGET; (B) IN THIS CONNECTION, MISSION WOULD OBSERVE THAT UK TREASURY'S MODEL OF UK ECONOMY DOES NOT INCLUDE MONETARY SECTOR, BUT THAT JUDGEMENTS HAVE APPARENTLY BEEN MADE TO ACCOUNT FOR POSSIBLE MONETARY EFFECTS. MISSION WOULD ASK UK REP IF THIS IS STILL THE CASE, AND IF SO, TO ELABORATE FURTHER ON CRITERIA WHICH TEND TO UNDERLY SUCH JUDGEMENTAL ADJUSTMENTS; (C) SECRETARIAT PUTS IMPROVEMENT IN BRITISH

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EXPORT PRICES OF MANUFACTURES RELATIVE TO UK COMPETITORS
AT 7 PERCENT BETWEEN END 1975 AND END 1976. IN VIEW OF
DETERIORATION IN RELATIVE UK COST PERFORMANCE AND OF
SECRETARIAT ESTIMATE THAT UK TERMS OF TRADE DETERIORATE
BY ONLY 1 PERCENT LAST YEAR (WHICH, ASSUMING STERLING
IMPORT PRICES INCREASED BY FULL AMOUNT OF DEPRECIATION,
IMPLIES THAT EXPORT PRICES ROSE NEARLY CONCOMMITANTLY). MISSION
IS SOMEWHAT SURPRISED BY SECRETARIAT CALCULATIONS AND
WOULD ASK FOR UK VIEWS ON THIS SUBJECT; (D) UK UNION
LEADERS HAVE RECENTLY EXPRESSED DISSATISFACTION WITH
INCOMES POLICY AND HAVE COMPLAINED THAT REDUCTION IN
UNEMPLOYMENT, PROMISED REWARD FOR WAGE RESTRAINT, HAS
NOT MATERIALIZED. UK REPS TO VARIOUS OECD MEETINGS HAVE
INDICATED THAT PROGRESS ON EMPLOYMENT FRONT IS IMPORTANT
TO MAINTENANCE OF WAGE MODERATION. YET, SECRETARIAT
FORECAST RISE IN UNEMPLOYMENT TO 1.5 MILLION THIS YEAR.
MISSION WOULD ASK UK REP IF HMG AGREES WITH SECRETARIAT
UNEMPLOYMENT PROJECTION AND WOULD BE INTERESTED IN HEAR-
ING MAIN LINES OF ARGUMENT HMG WOULD USE TO GET UNIONS
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TO BUY ANOTHER YEAR OF INCOMES POLICY IF EMPLOYMENT
SITUATION DOES DETERIORATE; (E) SECRETARIAT SUGGESTS THAT

PHASE III WAGE AGREEMENT SHOULD BE BASED ON UNIFORM PERCENTAGE INCREASES IN ORDER TO AVOID FURTHER COMPRESSION OF WAGE DIFFERENTIALS. MISSION WOULD SOLICIT UK REACTION TO SECRETARIAT RECOMMENDATION; (F) SECRETARIAT ALSO SUGGESTS THAT CAUTIOUS TAX CUTS MIGHT BE IN ORDER AT HIGH AND LOW ENDS OF INCOME SCALE TO INCREASE WORK INCENTIVES IN FORMER CASE AND TO AVERT "POVERTY TRAP" SYNDROME IN LATTER. MISSION WOULD ASK UK TO COMMENT ON THIS RECOMMENDATION AS WELL; (G) REF B INDICATES THAT PROGRESS UNDER NEW INDUSTRIAL STRATEGY IS NOT ALL THAT IT COULD BE. MISSION WOULD ASK UK REP TO DESCRIBE DEVELOPMENTS IN THIS AREA DURING 1976; (H) RECENT EVIDENCE SUGGESTS THAT DEPRECIATION OF STERLING HAS, BY INCREASING STERLING VALUE OF FOREIGN CURRENCY LIABILITIES, REDUCED CAPITAL/LIABILITY RATIO OF UK BANKS WHICH CARRY ON EXTENSIVE OPERATIONS IN FOREIGN CURRENCY. MISSION WOULD ASK UK REP FOR HMG ASSESSMENT OF SERIOUSNESS OF THIS PROBLEM; (I) IN DISCUSSING UK'S POLICY OPTIONS FOR MEDIUM-TERM, SECRETARIAT STATES THAT MODERATE GROWTH OF PRIVATE CONSUMPTION WILL BE NECESSARY TO ENCOURAGE INVESTMENT AND THUS TO INSURE THAT RESOURCES RELEASED FROM PUBLIC SECTOR ARE "PICKED UP" BY PRIVATE SECTOR. MISSION WOULD NOTE THAT NECESSARY PRECONDITION FOR MAKING THIS CONSIDERATION RELEVANT IS THAT RESOURCES ARE IN FACT RELEASED FROM PUBLIC SECTOR AND WOULD STRESS NEED FOR UK TO INTENSIFY ITS EFFORTS TO REDUCE PUBLIC EXPENDITURE OVER MEDIUM TERM.

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Message Attributes

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Capture Date: 01-Jan-1994 12:00:00 am
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